Treasury and IRS guidance on partnership ““basis shifting”” transactions

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Introduction

The U.S. Department of the Treasury and IRS on June 17, 2024, released three guidance packages related to certain "basis-shifting" transactions involving partnerships and related parties (and certain tax-indifferent parties) that the government perceive as abusive.

- Notice 2024-54 ("Notice") announces the Treasury and the IRS's intent to publish two sets of forthcoming proposed regulations related to certain transactions ("Covered Transactions").
- In addition, Treasury and the IRS released proposed regulations (REG-124593-23) ("Proposed Regulations") identifying certain partnership related-party basis adjustment transactions and substantially similar transactions as transactions of interest (TOI).
- Finally, Treasury and the IRS released Rev. Rul. 2024-14 (the "Revenue Ruling") clarifying when the economic substance doctrine (ESD) may apply to disallow tax benefits associated with certain basis-shifting transactions involving partnerships and related parties.

The government predicted that the announced approach could raise more than $50 billion in revenue over 10 years.

Targeted transactions

The guidance packages generally target three types of basis-shifting transactions that Treasury and the IRS perceive to be abusive. The transactions generally involve partners capitalizing on the disparity of the "outside" basis in their partnership interests as compared to their share of the partnership's "inside" tax basis of the assets. The transactions take the form of transfers of partnership interests between related parties, resulting in a section 743(b) basis adjustment, or current or liquidating distributions of particular assets between related partners, resulting in section 732 basis adjustments on distributed property and potentially section 734(b) basis adjustments of the remaining partnership property. The transactions of concern are generally tax-free and thus can result in a taxable benefit between the related parties without any economic outlay by them.

The guidance packages generally impact partnerships that have partners that are related parties. For purposes of each piece of guidance, partners and other persons would be considered as related if they have a relationship described in section 267(b) (without regard to section 267(c)(3)) or section 707(b)(1) immediately before or immediately after a transaction. However, the guidance would also impact similar transactions involving "tax-indifferent" parties—potentially including when a partner is tax-exempt, foreign, or has a tax-attribute (e.g., net operating loss (NOL)) if the gain from the transaction would not result in federal income tax liability or would be mitigated by the use of a tax-indifferent partner.

KPMG observation

While the introduction to the guidance points to curtailing transactions that generate tax savings from basis adjustments without a corresponding economic outlay, the rules outlined are very broad and, if promulgated, will engulf what many practitioners would consider routine transactions. As an example, the description of the Covered Transactions may capture common post-transaction restructurings such as where an acquirer purchases all of the direct and indirect (e.g., by purchasing the stock of a blocker) interests of a partnership and then immediately liquidates the partnership.

Additionally, if the guidance is finalized as described, the guidance packages could impact

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transactions that occurred prior to their finalization. Specifically, the rules contained in the Notice would impact the recovery of basis adjustments arising from transactions that occurred before the issuance of the guidance. Additionally, as detailed further below, the Proposed Regulations would impose onerous reporting requirements on partnerships, partners, and material advisors related to the TOI for certain prior transactions. As a result, taxpayers may need to re-analyze past transactions and should prepare for potential future financial statement impacts that may result if the guidance is finalized.

Of immediate interest, the Notice highlights that the Form 1120, *U.S. Corporation Income Tax Return*, includes a new question on Schedule K (Question 31), that is applicable to certain consolidated groups for any tax year ending on or after December 31, 2023. Specifically, the question asks consolidated groups with gross receipts or sales of $1 billion or more to report certain subchapter K basis adjustments. The intent is for taxpayers to identify certain related-party basis adjustment transactions that were entered into by members of the consolidated group in consolidated years ending on or after December 31, 2023. The identified related-party basis adjustment transactions in the instructions are not necessarily the same as those otherwise identified as part of the guidance. Specifically, the instructions are relevant for each partnership where 80% or more of the capital or profits of the partnership is owned, directly or indirectly, by members of the corporation's controlled group of corporations (as defined in section 1563), which make any basis adjustment of $10 million or more at the end of the tax year <u>and at any other relevant date</u> [emphasis added].

Notice 2024-54 — forthcoming guidance

Notice 2024-54 ("Notice") announces that Treasury and the IRS intend to publish two sets of forthcoming proposed regulations, the Proposed Related-Party Basis Adjustment Regulations and the Proposed Consolidated Return Regulations. The Proposed Related-Party Basis Adjustment Regulations address certain basis shifting transactions involving the targeted transactions described above, referring to them as "Covered Transactions."

Proposed related-party basis adjustment regulations

Overview

As mentioned, the Notice provides that the first set of proposed regulations will address basis adjustments resulting from related party Covered Transactions, the "Proposed Related-Party Basis Adjustment Regulations." These regulations would restrict the ability of partners and partnerships to derive any deemed inappropriate tax benefit (such as increased cost recovery allowances or reduced gain—or increased loss—upon sale or disposition) from a basis adjustment arising from a Covered Transaction. Importantly, however, the Notice states that the future guidance will apply to all Covered Transactions (as described below) "<u>without regard to the taxpayer's intent and without regard to whether the transactions could be abusive or lacking in economic substance</u> [emphasis added]."

As described in more detail below, the Notice provides that the cost recovery of any basis increase would be subject to a specific set of rules providing the method of recovering the basis adjustment and the treatment of the basis adjustment upon sale.

The Notice also provides that the forthcoming proposed guidance would apply to Covered Transactions that involve other related provisions, including section 732(d) and (f). Lastly, the Notice suggests that the forthcoming guidance will address these rules in tiered-partnership structures.

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KPMG observation

As articulated by the Treasury and the IRS, the rationale for the Notice is that they are aware of "various partnership transactions… in which basis adjustments were created to artificially generate or regenerate Federal income tax benefits that resulted in significant tax savings without a corresponding economic outlay." However, the only transactions that would be subject to the rules in the Notice are ones that would have a substantial non-tax business purpose as articulated by the economic substance doctrine codified in section 7701(o). Transactions that do not have economic substance are not subject to the Notice but are instead subject to a revenue ruling issued at the same time and described below.

There are a number of situations that can give rise to inside-outside basis disparities as a result of routine applications of existing statutory provisions in subchapter K. The application of Section 704(c), for example, which was enacted to prevent the inappropriate shifting of built-in gains and losses between partners, can result in "ceiling rule" limitations under the traditional method that create inside-outside basis disparities for a noncontributing partner if the section 704(c) property of the partnership does not provide sufficient tax cost recovery to match their economic entitlement to depreciation or amortization deductions under section 704(b). Additionally, the section 163(j) interest expense limitation of a partnership results in inside-outside basis disparities in dispositions of partnership interests that have been allocated excess business interest expense. These situations, and many others, are far from being "undertaken with a view to creating a disparity," and could nevertheless result in benign distributions and exchanges giving rise to limitations on the recovery of Congressionally sanctioned basis adjustments if the rules in the Notice are adopted.

Covered transactions

The Notice highlights three Covered Transactions:

- **Section 734(b) Covered Transaction**: The Notice describes a "Section 734(b) Covered Transaction" as one when a partnership with a section 754 election and two or more partners that are related to each other makes a current or liquidating distribution of a relatively high basis asset to one or more related partners (the "distributee partner"). The distributee partner has a relatively low basis in its partnership interest causing a basis step down of the property received under section 732. As a result, the partnership will make a section 734(b) adjustment to its remaining assets equal to the excess of the partnership's basis in the distributed property over the basis of the distributed property in the hands of the distributee partner. The section 734(b) basis adjustment is then allocated to the partnership's assets under section 755.

- **Section 743(b) Covered Transaction**: A "Section 743(b) Covered Transaction" generally occurs when the following three prongs are met: (1) a partner transfers an interest in a partnership with a section 754 election in effect or a substantial built-in loss immediately after such transfer; (2) the transfer is to a related transferee (i.e., related to the transferor) or a transferee that is related to one or more of the partners; and (3) the transfer is a nonrecognition transaction in which the gain recognized, if any, and for which tax imposed by subtitle A of the code is required to be paid, is less than the aggregate amount of the section 743(b) basis increase(s). The section 743(b) basis adjustment is then allocated to the partnership's assets under section 755. The Notice highlights that this fact pattern can only arise in the event that the transferee partner(s) has an inside-outside basis disparity with respect to its partnership interest with the section 743(b) adjustment eliminating the basis disparity.

- **Section 732 Covered Transaction**: A "Section 732 Covered Transaction" results from a distributee partner receiving a liquidating distribution of property resulting in a basis increase to the distributed property under section 732 and either: (1) the partnership liquidates and distributes the partnership's remaining partnership property to one or more partners related to the distributee partner (a "related distributee partner") resulting in a basis adjustment that reduces the basis of such property to the related distributee partners under section 732, or (2) the partnership continues, and a related party to

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the distributee partner is a continuing partner (a "related continuing partner") that has a share of the partnership's basis decrease under section 734(b) or (d) resulting from the liquidating distribution or would have had a share of the partnership's basis decrease under section 734(b) if the partnership had a section 754 election in effect.

KPMG observation

The rules as outlined in the Notice do not appear to have any thresholds with respect to the relatedness of the partners to the partnership and could apply even where the related partners have a relatively small combined ownership of the partnership. For example, a transaction entered into by a partner where the related partners own less than 5% of a partnership could subject the partnership to these rules on any related basis adjustment.

The Section 743(b) Covered Transaction definition includes a related party sale of an interest if the aggregate increase(s) in basis of partnership property under section 743(b) with respect to the related transferee is more than "the gain recognized, if any, and for which tax imposed by subtitle A of the code is required to be paid…" The language contained in the Notice is unclear and could be read to compare the basis adjustment to the gain recognized or compared to the tax paid on the gain recognized. The final guidance will need to clarify this point.

Also note that related party status is nuanced. First, relatedness is tested immediately before and immediately after the transaction. Second, the Covered Transaction rules apply in situations where the transaction is with an unrelated party, but there are related partners in the partnership at the time of the transaction. This latter situation may pose a structuring consideration for taxpayers on whether to invest in a partnership through more than one related entities.

Treatment of related-party basis adjustments

The Notice outlines specific guidance as to the treatment of the basis adjustment(s) resulting from Covered Transactions (i.e., a related-partner basis adjustment (RPBA)) described in the guidance as a Section 743(b) RPBA, Section 734(b) RPBA, and a Section 732 RPBA).

KPMG observation

As highlighted further below, the application of the RPBA rules to basis-adjusted assets is intended to delay utilization of the basis increase, including potentially slowing down or stopping cost recovery, rather than eliminating the basis increase entirely. This treatment is distinguishable from Covered Transactions that have factual elements suggesting lack of economic substance in which the basis adjustment is simply disregarded (see discussion of Rev. Rul. 2024-14 below).

The rules will require partnerships and partners to specially track the classification of the asset to identify what portion of the asset is not subject to the rules (e.g., the "share" of the basis that is attributable to partners unrelated to the transferee and, in the case of section 743(b) RPBAs, the portion of the basis increase attributable to gain recognized (and for which tax was paid) by the transferor) and also to identify when the basis-adjusted asset ceases to be an RPBA. For example, with respect to a section 734(b) basis increase, the partnership, or any "subsequent transferee" (as discussed below) has to find out from a distributee partner, perhaps even one that is no longer a partner, whether the distributed property that caused the basis increase was sold in a Qualifying Disposition (as discussed below).

Section 734(b) RPBAs

General rules: The portion of a section 734(b) basis adjustment resulting from a Section 734(b) Covered Transaction attributable to a related partner of the distributee partner is a "Section 734(b) RPBA." The

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portion of the section 734(b) basis adjustment attributable to a related partner will be determined under principles similar to those outlined in the section 734(b) basis adjustment provisions in the anti-churning regulations (specifically, Treas. Reg. section 1.197-2(h)(12)(iv)(D)).

A Section 734(b) RPBA will be recovered using the cost recovery method and remaining recovery period, if any, as the corresponding distributed property that gave rise to the Section 734(b) RPBA. For instance, if a partnership distributed land to the distributee partner, there would be no cost recovery on any associated Section 734(b) RPBA, regardless of what the section 734(b) basis adjustment was allocated to. In addition, the partnership would not be eligible to take the Section 734(b) RPBA into account upon the sale or other disposition of partnership property to which a Section 734(b) RPBA applies. Both of these limitations are applied until the corresponding property is disposed in an arm's length transaction with an unrelated person in a transaction in which taxable gain or loss is fully recognized (a "Qualifying Disposition").

KPMG observation

The proposed rule attempts to use something of an aggregate approach in analyzing the related-party benefit created by a basis-shifting distribution. To the extent that a basis decrease in distributed property under section 732(a) produces a basis increase in partnership property under section 734(b), the proposed rule would adjust cost-recovery with respect to any related partner's share of the section 734(b) basis adjustment, essentially treating each partner as directly holding its share of the section 734(b) basis adjustment. Section 197(f)(9)(E) takes a similar approach in analyzing partnership basis adjustments for purposes of the anti-churning rules, and the Notice incorporates Treas. Reg. section 1.197-2(h)(12)(iv)(D) for purposes of analyzing distribution transactions. That regulation determines a partner's share of a section 734(b) basis adjustment based upon the partner's proportionate section 704(b) capital account (maintained in accordance with Treas. Reg. section 1.704-1(b)(2)(iv)), if the partnership maintains qualifying capital accounts, or otherwise based upon the partner's overall interest in the partnership, determined immediately after the distribution under the "partners' interests in the partnership" rules provided by Treas. Reg. section 1.704-1(b)(3). By determining a partner's share of the section 734(b) basis adjustment by reference to a partner's capital account or overall share in the partnership at a particular point in time, distortions may result where a partnership incorporates disproportionate allocations with respect to specific assets or where a snapshot of a partner's interest does not reflect the partner's potential overall share in the partnership over time (e.g., a preferred/common partnership or a partnership with a tranched carry arrangement). In addition, as highlighted in the context of section 197, the conformance of capital accounts to the economic arrangement of the partners can become quite complicated when partners with an intended proportionate sharing in assets determine cost recovery with respect to those assets over different periods. See Treas. Reg. section 1.197-2(h)(12)(iv)(F) & (k), Ex. 31.

To the extent a distributee partner receives a non-liquidating distribution from the partnership, it is unclear from the Notice if the Section 734(b) RPBA would include the portion of the basis adjustment attributable to the distributee partner. The finalized guidance will need to clarify this point.

Ceases to be rules: A section 734(b) RPBA will cease to be a section 734(b) RPBA after a Qualifying Disposition by the distributee partner of the corresponding distributed property. In the event of a Qualifying Disposition, any remaining basis attributable to the former Section 734(b) RPBA is treated as a newly placed in service asset that is subject to the cost recovery period and method applicable to the property to which it was allocated and the basis adjustment would be taken into account in computing gain or loss upon the disposition of the adjusted property.

KPMG observation

The ceases to be rules appear to hinge on the distribute partner disposing of the corresponding distributed property in a taxable transaction with an unrelated party and then notifying the partnership of this event. It is currently unclear whether the partnership will need to independently verify the

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information provided from the distributee partner or if it can simply rely on the information given to it. In any event, this rule, amongst many others in this Notice, will require a tremendous amount of information sharing between parties that does not currently take place.

Additionally, the ceases to be rules do not appear to consider a situation in which the distributee partner and any related partner completely dispose of their interests in the partnership. Thus, it appears the partnership would need to maintain communication with any distributee partner from a Section 734(b) Covered Transaction until the Section 734(b) RPBA ceases to be. It is unclear whether this communication will be mandated in the regulations, or whether this will become a contractual term between parties.

Lastly, the ceases to be rules would not apply if the distributed property is disposed of by the distributee partner in a transaction in which gain is deferred, such as a like-kind exchange or an involuntary conversion. Query as to whether it is appropriate for the recovery of the partnership to be dependent upon the manner in which the distributee partner disposes of the property.

Successor rules: In the event a partnership distributes property subject to a Section 734(b) RPBA, the partner will take into account the Section 734(b) RPBA in determining the basis of the asset in its hands and for purposes of the distributee partner's basis in its interest. For example, if the partnership distributed Asset X with an adjusted basis of $100x and a corresponding Section 734(b) RPBA of $10x, the partner's basis in Asset X would be $110x, assuming no adjustments are required under section 732. The Section 734(b) RPBA taint would remain until there is a Qualifying Disposition.

In the event the partnership (or partner in the event the property was distributed to a partner) disposes of property to which a Section 734(b) RPBA applies, the amount of any remaining Section 734(b) RPBA would be reallocated to other property of the partnership (or the partner) under rules similar to the rules for allocating section 734(b) basis adjustments (specifically, Treas. Reg. section 1.755-1(c)). If the partnership (or partner) cannot reallocate a Section 734(b) RPBA (because the partnership (or partner) does not own property of a like character), the reallocation would carryover and be made when property of a like character is subsequently acquired by the partnership (or partner).

KPMG observation

The finalized guidance will need to address the impact of any section 732 basis increase or decrease required by the distribution of property subject to a Section 734(b) RPBA.

These allocation rules require the Section 734(b) RPBA to be reallocated to property of a like character to the asset that is disposed of by the partnership (or partner distributee). If the partnership (or partner distributee) does not have assets of a like character to reallocate the Section 734(b) RPBA to, the basis adjustment may be suspended until the partnership or transferee acquires such property. Thus, it is possible that the basis adjustment can be suspended and potentially lost in its entirety.

If the partnership distributes an asset to a partner that has a Section 734(b) RPBA attached to it, the Section 734(b) RPBA rules do not make a distinction between a partner that was related to the original partner that received a distribution that resulted in the generation of the RPBA and an unrelated partner. If this was the intended result, to the extent property subject to a Section 734(b) RPBA is distributed to an unrelated distributee partner, there will likely need to be some coordination between the partnership, the distributee partner, and the unrelated distributee partner. The unrelated distributee partner will need to understand the portion of the distributed property allocable to a Section 734(b) RPBA and the cost recovery method and remaining recovery period, if any. Additionally, the unrelated distributee partner and distributee partner will need to coordinate such that if the distributee partner disposes of the property in a Qualifying Disposition, the unrelated distributee partner is notified.

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Thus, partnerships or other entities which receive assets from a partner will need to diligence the history of the assets to determine whether the special basis provisions that are applicable to an RPBA apply.

Section 743(b) RPBAs

General rules: A Section 743(b) RPBA will result in the event of a Section 743(b) Covered Transaction. If any gain is recognized on the Covered Transaction, the portion of the basis increase attributable to the gain would not be treated as a section 743(b) RPBA. A Section 743(b) RPBA will be ineligible for cost recovery until the transferee partner becomes unrelated to both the transferor partner and to all existing partners. In addition, the transferee partner generally will not be able to take into account the Section 743(b) RPBA upon the sale or other disposition of partnership property to which the Section 743(b) RPBA applies.

KPMG observation

It is unclear from the language of the Notice how to determine the portion of the basis increase that is not treated as a Section 743(b) RPBA. It appears the intent is to make the Section 743(b) RPBA equal to the excess section 743(b) basis adjustment over any gain (on which tax is imposed and is required to be paid) recognized in the nonrecognition transaction. The guidance will need to clarify this.

In the event the transferor partner recognizes gain on the nonrecognition transaction, the portion of the section 743(b) adjustment equal to the amount of the gain recognized will be subject to the normal section 743(b) rules. The remaining section 743(b) adjustment will be considered a Section 743(b) RPBA and will be subject to the forthcoming special basis shifting rules. Hopefully, additional rules will be added to address when the section 743(b) basis adjustment is allocated to more than one property under section 755.

KPMG observation

The Notice does not appear to provide any exception for section 743(b) basis adjustments that initially result from other than a Covered Transaction. For example, consider a taxpayer with an existing section 743(b) adjustment with respect to a partnership interest that was previously acquired from an unrelated third party in a fully taxable, arm's-length transaction (the original section 743(b) adjustment) who transfers the interest into an upper-tier partnership in a Covered Transaction under the Notice. In general, under the existing current section 743 regulations, if there is a subsequent transfer of a partnership interest, the transferor's original section 743(b) adjustment is eliminated and a new section 743(b) adjustment is created for the benefit of the transferee (the new section 743(b) adjustment). Under the Notice, if the subsequent transfer is a Covered Transaction, the new section 743(b) adjustment could become a Section 743(b) RPBA even though the original section 743(b) adjustment did not arise from a Covered Transaction and reflects the prior real economic outlay by the transferor for which tax was paid. We believe this result is inappropriate and unintended.

It is worth noting that, in 2014, Treasury and the IRS issued proposed regulations under section 743 ("2014 Proposed Regulations") that proposed to amend the subsequent transfer rule described above for certain substituted basis transactions. Proposed Section 1.743-1(f)(2), 79 FR 3042-01, 2014 I.R.B. 474 (January 16, 2014). Instead of eliminating the original section 743(b) adjustment of the transferor, under the 2014 Proposed Regulation, in the case of certain substituted basis transactions, the transferee would succeed to the transferor's original section 743(b) adjustment attributable to the interest transferred in the subsequent transfer. In the preamble to the 2014 Proposed Regulations, the government explained that an exception was needed because "Treasury and IRS believe that [the current] rule can lead to inappropriate results when the transferor transfers

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its partnership interest in a substituted basis transaction (a “one-directional adjustment”) and the transferor had a basis adjustment under section 743(b) attributable to the transferred interest that was allocated pursuant to section 1.755-1(b)(2) through (b)(4) (a “two-directional adjustment”). Under the current rules, the transferee does not succeed to the transferor’s section 743(b) adjustment but, rather, is entitled to a new section 743(b) adjustment that is allocated under a different set of rules, which may result in the inappropriate shifting of basis among the partnerships assets.” [emphasis added]. Therefore, the 2014 Proposed Regulations instead would provide that the transferee in a substituted basis transaction succeeds to that portion of the transferor’s two-directional basis adjustment attributable to the transferred partnership interest and that the adjustment is taken into account in determining the transferee’s share of the adjusted basis to the partnership for purposes of section 1.743-1(b) and 1.755-1(b)(5).

In simple terms, to prevent basis shifting, the 2014 Proposed Regulations intended to prevent a substituted basis transaction from converting a “two-directional adjustment” (that is an adjustment that has both positive and negative amounts) into a “one-directional adjustment” by requiring the transferee to maintain the transferor’s original section 743(b) adjustment. A similar rule should be considered under any proposed regulations resulting from the Notice to allow the transferee in a substituted basis transaction to succeed to that portion of the transferor’s basis adjustment attributable to the transferred partnership interest when the transferor’s basis adjustment resulted from other than a Covered Transaction.

Ceases to be rules: A Section 743(b) RPBA will cease to be a Section 743(b) RPBA when the transferee partner ceases to be related to both the transferor and all persons who were partners immediately before or immediately after the Section 743(b) Covered Transaction. If a basis adjustment ceases to be a Section 743(b) RPBA, the basis attributable to the former Section 743(b) RPBA would be treated as giving rise to a newly placed in service asset that is subject to the cost recovery period and method of the asset to which it was originally allocated, and the basis adjustment would be taken into account in computing gain or loss upon the sale or other disposition of the property.

KPMG observation

Transferees of partnership interests in a Section 743(b) Covered Transaction will need to be diligent in informing the partnership when they are no longer related to the transferor of the interest and/or all of the partners that were related partners to the transferee immediately before and immediately after the Section 743(b) Covered Transaction.

Successor rules: If a partnership distributes property with respect to which there is a Section 743(b) RPBA to the transferee partner, the transferee partner would take into account the Section 743(b) RPBA in determining the basis of the property in its hands under section 732. However, the basis adjustment would remain ineligible for cost recovery and would not be used in computing gain or loss on the sale or disposition until the basis adjustment ceases to be a Section 743(b) RPBA under the rules described above.

If a partnership (or a transferee partner) disposes of property to which a Section 743(b) RPBA applies, then the amount of the Section 743(b) RPBA would be reallocated to other property under rules similar to the rules for allocating a section 734(b) basis adjustments (specifically, Treas. Reg. section 1.755-1(c)) and would remain a Section 743(b) RPBA. If the partnership (or transferee partner) cannot reallocate a Section 743(b) RPBA (because the partnership or partner does not own property of a like character), the reallocation would be made when property of a like character is subsequently acquired.

KPMG observation

As discussed above with respect to the successor rules for a Section 734(b) basis adjustment, the reallocation rules for a Section 743(b) RPBA could result in the basis adjustment being lost in its

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entirety if the partnership does not have assets, or later does not acquire assets, of a like character to which to reallocate the Section 743(b) RPBA.

This rule applies to all dispositions by the partnership, other than a distribution to the transferee partner that has the Section 743(b) RPBA. Application of this rule to certain ordinary course transactions can be surprising. For instance, a partnership that contributes assets to which a Section 743(b) RPBA exists to a lower-tier partnership appear to be subject to this reallocation rule. This appears to apply even though the transferee partnership is required to trace the section 743(b) adjustment back to the contributing upper-tier partnership, which traces it back to the original transferee (as described in Treas. Reg. section 1.743-1(h)(1)). In this case, the reallocation of a Section 743(b) RPBA seems odd, and if the upper-tier partnership has transferred all of its assets to the lower-tier partnership, the Section 743(b) RPBA would seem to be suspended.

Similar to the rules discussed above with respect to the successor rules for a Section 734(b) basis adjustment, the concept of a subsequent transferee means that partnerships or other entities which receive assets from a partner will need to diligence the history of the assets to determine whether the special basis provisions that are applicable to a Section 743(b) RPBA apply.

Section 732 RPBAs

General rules: In the case of a partnership liquidation, a Section 732 RPBA will result when a partner increases the basis of property distributed to it and another partner related to that distributee partner (a "related distributee partner") decreases the basis of distributed property distributed to it under section 732. The resulting Section 732 RPBA would be recovered using the cost recovery method and remaining recovery period, if any, of the corresponding property the basis of which a related distributee partner reduced. In addition, the distributee partner would not be eligible to take the Section 732 RPBA into account upon the sale or other disposition of the property to which the Section 732 RPBA applies until such time as there is a Qualifying Disposition of the corresponding property, as discussed further below. These rules would not apply to any portion of the basis increase that corresponds to a basis decrease to property distributed to an unrelated partner.

In the case of the partnership that does not liquidate, a Section 732 RPBA will result when a partnership makes a liquidating distribution to the distributee partner where property is stepped up and there is a resulting section 734(b) adjustment made at the partnership level (or there would have been if the partnership had a section 754 election in effect), that is attributable to a related distributee partner. The portion of the section 734(b) basis adjustment that is attributable to a related partner distributee partner is determined under principles similar to those outlined in the section 734(b) basis adjustment provisions in the anti-churning regulations (specifically, Treas. Reg. section 1.197-2(h)(12)(iv)(D)). These rules would not apply to any portion of the basis increase that corresponds to the share of any basis decrease under section 734(b) of a partner unrelated to the distributee partner (or the unrelated partner's share of a basis decrease under section 734(b) if the partnership had a section 754 election in effect). The resulting Section 732 RPBA would be recovered using the cost recovery method and remaining recovery period, if any, of the corresponding property the basis of which the partnership reduced under section 734(b) or would have reduced under section 734(b) if the partnership had a section 754 election in effect, until there is a Qualifying Disposition of the corresponding property. In addition, the distributee partner would not be eligible to take the Section 732 RPBA into account upon the sale or other disposition of the property to which the Section 732 RPBA applies until there is a Qualifying Disposition.

KPMG observation

As with the benefit created by a Section 734(b) RPBA when the adjusted basis of distributed property is stepped down, the Notice takes a similar aggregate approach for purposes of analyzing positive section 732 RPBAs that result in an offsetting downward basis adjustment to remaining partnership assets under section 734(b). The observation above relating to the application of the aggregate

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approach in analyzing section 734(b) RPBAs applies equally to section 732(a) RPBAs.

Note that the Section 732 RPBA corresponding asset rules apply even if there is no corresponding basis adjustment made at the partnership level under section 734(b) because the partnership does not have a section 754 election in place and there is no section 734(b) decrease large enough to be required under the substantial basis reduction rules. Thus, the impact of these provisions can be felt by partnerships that otherwise thought they were not subject to the rules due to lack of a section 754 election; partnerships with related partners need to be cognizant of the impact if one of those partners is fully redeemed.

In the case of a Section 732 Covered Transaction that does not result in a liquidation of the partnership, the partnership would be required to compute a section 734(b) basis adjustment, allocate the section 734(b) adjustment to the partnership's assets under section 755, and determine the portion of the section 734(b) basis adjustment attributable to any related distributee partners even when the partnership does not have a section 754 election in effect (or result in a substantial built in loss). This places additional administrative burden on the partnership that may not have existed prior to these rules.

In the case of multiple distributed properties, each distributed property would be treated as having a separate Section 732 RPBA with respect to each basis decrease attributable to a corresponding property. The amount of a Section 732 RPBA would be proportionate to the share of the basis decrease to that Section 732 RPBA's corresponding property out of the aggregate basis decrease to all corresponding properties. For instance, consider if a partnership distributed Property A and Property B to a distributee partner, which caused a step up of Property A by $10x and Property B by $5x. Assume these step-ups caused the partnership to step-down Land C by $7.5x and Land D by 7.5x. Further assume that of these step-downs 20% would be attributable to a related distributee partner. As such, of the $10x step-up under section 732 to Property A, $2x would be treated as a Section 732 RPBA ($1x attributable to Land C and $1x attributable to Land D). Additionally, of the $5x step-up to Property A, $1x would be treated as a Section 732 RPBA ($0.5x attributable to Land C and $0.5x attributable to Land D).

Ceases to be rules: A Section 732 RPBA will cease to be a Section 732 RPBA upon a Qualifying Disposition of the corresponding property. If a basis adjustment ceases to be a Section 732 RPBA, the remaining basis attributable to the former Section 732 RPBA would be treated as giving rise to a newly placed in service property that is subject to the cost recovery period and method of the distributed property, and the basis adjustment would be taken into account in computing gain or loss upon the sale or other disposition of the property.

KPMG observation

The requirement that the corresponding property be disposed of in a fully taxable transaction to an unrelated person in an arm's length transaction can result in a loss of the Section 732 RPBA in several benign situations. For example, if the Section 732 RPBA is on the interest in an entity such as a corporation and that corporation is liquidated under section 331 or 332 (or is absorbed in a merger transaction) the Section 732 RPBA appears to be forever tainted and lost as there are no successor Section 732 RPBA rules in this context as the asset itself is extinguished. In addition, it is unclear if deemed exchanges can count as a disposition for purposes of these rules (e.g., if an S corporation is the distributee Section 732 RPBA holder and there is a section 338 election made on a taxable sale of its stock to an unrelated buyer which involves a deemed sale of the basis-adjusted asset held by the S corporation). Furthermore, as there appear to be no successor tracing rules, if there is a fully taxable disposition of the basis adjusted asset on a transfer to a related party (in a section 331 liquidation of the distributee partner, for example), there is no described tracing rule that could follow the sale of the sold asset by that party to an unrelated party.

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Tax indifferent parties

The forthcoming guidance will also apply to Covered Transactions that involve other related subchapter K provisions (such as sections 732(d) and 732(f)), and additional steps, as well as to tiered partnership structures and would also treat as Covered Transactions certain partnership arrangements involving taxable and tax-indifferent parties that would otherwise not be a Covered Transaction due to the parties being unrelated. A tax-indifferent party would be defined as a person that is either not liable for Federal income tax (e.g., because the partner is tax exempt or possibly due to the partner's foreign status) or to which gain from the transaction would not result in federal income tax liability for the person's tax year within which such gain is recognized (e.g., because for example the partner has an NOL).

KPMG observation

First, it is unclear what is meant by "additional steps" in the notice. Second, consideration will need to be given to the administrative burden of applying these rules in tiered settings. Specifically, to comply with these rules, it could be the case that any partnership in a structure would need to obtain additional information from its partners to ascertain if these rules would apply. In some circumstances, it may be enough to just know the partner's type (e.g. knowing the partner is a tax-exempt); however, the partnership would need to be privy to a lot more information to determine if the partner had to recognize gain on the transaction. Further, questions may arise as to how much the partnership will need to independently verify the information provided from the partner or if the partnership can simply rely on information given to it.

Applicability date

Treasury and the IRS intend to propose that the Related-Party Basis Adjustment Regulations, when finalized, would have an applicability date of June 17, 2024, the date the Notice was issued. Further, the Notice states that once finalized, the regulations would govern the availability and amount of cost recovery deductions and the computation of disposition gain or loss for tax years ending after the effective date, even if the relevant Covered Transaction was completed in a prior tax year.

KPMG observation

If the final regulations maintain the proposed applicability date, it appears that any positive basis adjustment resulting from a Covered Transaction would be subject to the rules regardless of when the Covered Transaction occurred. As such, taxpayers would need to re-analyze transactions that were completed prior to the Notice's release date to determine if the transaction would be considered a Covered Transaction. If it would be, any remaining positive basis increase would become subject to these rules.

Note that there are currently final regulations in place that govern the recovery of basis adjustments. The Notice provides that the Treasury and the IRS intend to propose that the Treasury decision that adopts the Proposed Related-Party Basis Adjustment Regulations of the Notice as final regulations would apply to taxable years ending on or after June 17, 2024. That is, once finalized, the regulations would govern the availability and amount of cost recovery deductions and gain or loss calculations for taxable years ending on or after June 17, 2024 even if the relevant covered transaction was completed in a prior year. The retroactive nature of the regulations, once finalized, will create uncertainty for taxpayers perhaps for many upcoming years. Assuming that any final regulations are consistent with the Notice, if a taxpayer has entered into a transaction which is considered a Covered Transaction (including, as discussed elsewhere, routine transactions), the taxpayer will have recovered the basis under the current final regulations. Guidance will be needed to instruct taxpayers as to how take into account the depreciation or gain or loss impact imposed by the new regulations. Will the impact be taken into account as a change in the method of accounting? Will the change be automatic? What if the property is sold in the intervening years? What if the property

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> is contributed to a partnership in an intervening year? What if the section 704(c) method selected by the transferee partnership would be impacted by the redetermined basis? Consideration should be given to the uncertainty and administrative burden placed on taxpayers who are simply following – as they must – the final regulations that are in place today.

Proposed consolidated return regulations

The Notice provides that a second set of proposed regulations, the Proposed Consolidated Return Regulations, would be issued under section 1502. Treasury and the IRS are concerned that some consolidated groups have used Covered Transactions to alter the taxable income or overall tax liability of the consolidated group. As such, the Notice would apply a single-entity approach with respect to interests in a partnership held by members of a consolidated group. The reason stated in the Notice for these rules is to prevent direct and indirect basis shifts among members of a consolidated group.

The proposed applicability date of the forthcoming Proposed Consolidated Return Regulations will not be tied to the Notice's release date and will be specified in the forthcoming Proposed Consolidated Return Regulations package.

> **KPMG observation**
>
> The IRS has taken the position in prior administrative guidance that Treas. Reg. section 1.1502-13's intercompany transaction rules can apply to redetermine items resulting from the transfer of a partnership interest between consolidated group members (e.g., increased depreciation/amortization deductions resulting from a nonrecognition transfer of a partnership interest in an intercompany transaction may be redetermined to be noncapital, nondeductible amounts). Notice 2024-54's definition of a Covered Transaction is broader than the definition of an intercompany transaction, which is defined in Treas. Reg. section 1.1502-13(b)(1)(i) as "a transaction between corporations that are members of the same consolidated group immediately after the transaction." Accordingly, although not known what approach the Proposed Consolidated Return Regulations will take to achieve a single-entity result, it is possible that such regulations could impact a broader range of transactions involving partnerships and consolidated group members than those covered by Treas. Reg. section 1.1502-13.

Proposed regulations — reportable transactions

In addition, Treasury and the IRS released proposed regulations (REG-124593-23) "Proposed Regulations" that would identify certain partnership related-party basis adjustment transactions and substantially similar transactions as transactions of interest (TOI), a type of reportable transaction. The Proposed Regulations place disclosure requirements on certain partnerships, partners, and advisors and attach significant penalties for failure to disclose.

The TOIs describe four variations of the targeted transactions described above that result in basis adjustments under sections 732(b) or (d), 734(b), or 743(b). The Proposed Regulations cover substantially similar transactions to the Covered Transactions described in the Notice—including transactions that do not involve related partners but instead involve tax-indifferent partners (e.g., tax-exempt partners, certain foreign partners, and certain partners with NOLs). The threshold for reporting the transactions of interest is set at $5 million or more of positive basis adjustments generated through the four targeted transactions outlined in the regulations. The Proposed Regulations provide detailed disclosure requirements for a

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partnerships and partners that enter into one of four targeted transactions and meet the $5 million threshold.

Transactions of interest

As discussed above, the Proposed Regulations outline four TOIs. The first three are related to distributions by partnerships, and the last is related to transfers of partnership interests.

- **Section 734(b) TOI**: The partnership distributes property to a person who is a related partner (meaning the partnership has two or more direct or indirect partners that are related immediately before or immediately after the transaction) in a current or liquidating distribution, the partnership has a positive section 734(b) basis increase to one or more of its remaining properties as a result of the transaction, and the $5 million threshold (as discussed below) is met.

- **Section 732(b) TOI:** The partnership distributes property to a partner who is a related partner (meaning the partnership has two or more direct or indirect partners that are related immediately before or immediately after the transaction) in liquidation of the partner's partnership interest (or in complete liquidation of the partnership), the basis of one or more distributed properties is increased under section 732(b) and (c), and the $5 million threshold is met.

- **Section 732(d) TOI:** The partnership distributes property to a person who is a related partner (meaning the partnership has two or more direct or indirect partners that are related immediately before or immediately after the transaction), the basis of one or more distributed properties is increased under section 732(d), the related partner acquired all or a part of its interest in a nonrecognition transaction when the partnership did not have a section 754 election in effect, and the $5 million threshold is met.

- **Section 743(b) TOI:** A partner transfers an interest in a partnership to a related partner (meaning the transferor of a partnership interest is related to the transferee or the transferee is related to one or more of the partners in the partnership immediately before or immediately after the transaction) in a nonrecognition transaction, the basis of one or more partnership properties is increased under section 743(b), and the $5 million threshold is met.

- **Substantially similar transactions**. The proposed regulations would also apply to transactions substantially similar to the four specified above, as a TOI by definition includes transactions that are the same or substantially similar to a type of transaction that the IRS has identified by notice, regulation, or other form of published guidance as a TOI. The guidance provides two examples of substantially similar transactions but notes that this is not an exhaustive list. First, the rules would extend to transactions between unrelated parties if one or more of the partners is tax-indifferent. Generally, a tax-indifferent party is a person that is either not liable for Federal income tax because it is tax-exempt, foreign, or where gain would not result in a federal income tax liability due to the partner's tax attributes (e.g., where the partner has an NOL). Additionally, a substantially similar transaction also includes a transaction in which a partner transfers an interest in a partnership to a related partner in a recognition transaction and where the $5 million threshold is met.

- **$5 million threshold**. The $5 million threshold is met for a tax year if the sum of all gross basis increases (i.e., without netting for any basis decreases resulting from the same transaction) resulting from all such transactions of a partnership or partner during the tax year exceeds by at least $5 million the gain recognized from such transactions, if any, on which tax is imposed and is required to be paid by any of the related partners (or tax-indifferent party) to such transactions.

KPMG observation

In limiting the $5 million threshold to only the gains recognized by the related parties, the proposed regulations ignore the fact that a gain could have been recognized by an unrelated third party. If the proposed regulations were to be finalized in their current state, it would appear to define seemingly

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non-abusive transactions as a TOI and therefore subject to the disclosure requirements. For instance, it appears that many internal restructurings involving a partnership and occurring after a taxable transaction would fall under this guidance.

Disclosure requirements

Form 8886*, Reportable Transaction Disclosure Statement*, is required for each tax year in which a participant participated in a TOI. Additionally, the participating partnership, participating partners, and related subsequent transferees will have disclosure requirements in subsequent years in the event there is any cost recovery related to a basis adjustment resulting from a TOI or if the property subject to an increase in basis resulting from a TOI is disposed of in a subsequent year in which gain or loss is recognized in whole or in part. Failure to disclose could result in significant penalties.

For purposes of the reporting requirements, a participating partner is any partner in a TOI that directly receives a distribution of property or an interest in a participating partnership, or directly transfers an interest in a participating partnership, including a person that becomes or ceases to be a partner as a result of such transaction. A participating partnership is any partnership that distributes property to a participating partner in a TOI, or has a partnership interest transferred in a transaction described in TOI. A related subsequent transferee is any person who is related to a participating partner and directly received in a nonrecognition transaction, a transfer (including a distribution) of property that was subject to an increase in basis as a result of a TOI.

The disclosure must describe the transaction in sufficient detail and includes:

- Names and identifying numbers of all participants: the participating partnership, participating partners, related subsequent transferees, or tax-indifferent parties
- All basis adjustments resulting from a TOI
- Basis information, including the participating partnership's adjusted basis in the distributed property immediately before the distribution, any adjustments to basis under section 732 or 734(b), any adjustments to basis under section 743(b) with respect to a participating partner that is transferred an interest in a participating partnership, and, with respect to a participating partner that transfers an interest in a participating partnership, that participating partner's adjusted basis in the participating partnership interest and share of the participating partnership's adjusted basis in its property immediately before the transfer
- Federal income tax consequences realized during the year attributable to the increase in basis adjustment (cost recovery, taxable gain or loss)

Applicability date

The proposed regulations are proposed to apply as of the date of publication of final regulations in the Federal Register. However, taxpayers may be required to report transactions that occurred prior to the date of publication of the final regulations. Specifically, material advisors have disclosure requirements with regard to transactions occurring six years prior to the date the regulations are finalized.

KPMG observation

While the regulations are proposed not to apply until they are finalized, it appears that TOIs that closed before the finalization date may still be subject to the onerous reporting requirements by participants in the event there is any cost recovery related to an increase in basis resulting from a TOI or if the property subject to an increase in basis resulting from a TOI is disposed of in a subsequent year in which gain or loss is recognized in whole or in part.

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Additionally, material advisors would need six years' worth of prior transactions to accumulate a list of TOIs on which they advised.

Revenue Ruling 2024-14 — economic substance

Finally, Treasury and the IRS released Rev. Rul. 2024-14 (the "Revenue Ruling") clarifying when the economic substance doctrine "ESD) may apply to disallow tax benefits associated with certain basis-shifting transactions involving partnerships and related parties.

The Revenue Ruling outlines three scenarios in which the ESD will be raised. The scenarios all involve related parties, as defined under section 267(b) or 707(b)(1), that engage in the following series of events:

- The parties engaged in a concerted effort to create inside/outside basis disparities through various methods, including certain partnership allocations and distributions. While no specifics are provided, the Ruling provides examples for how the basis disparities were created and notes that they were done so "with a view of creating a disparity."
- The parties then exploited the created disparities by engaging in transfers resulting in basis adjustments under sections 732(b), 734(b), or 743(b) resulting from the nonrecognition transaction or distribution under the mechanical rules of subchapter K.
- The parties inappropriately reduced taxable income through increased deductions or reduced gain (or increased loss).

Of note, all three situations presented in the Revenue Ruling have the same business purpose – "to achieve cost savings for [the related parties] by cleaning up intercompany accounts, reducing administrative complexity, and achieving other administrative efficiencies." Additionally, in each of the situations, the cost savings resulting from the transaction are insubstantial as compared to the reduction in the income tax liability of the related parties due to the basis adjustment received as a result of the transaction.

The Ruling concludes that the series of transactions contemplated in each of the scenarios lack economic substance under section 7701(o). The ruling argues that outside the federal income tax benefits, the transaction did not change the economic position of the related parties and there was no substantial business purpose for entering into the transactions. As a result of the transaction lacking economic substance, the basis step-ups outlined are disregarded. However, the Revenue Ruling does not provide details regarding whether the other tax consequences of the transactions are disregarded. A footnote to the Revenue Ruling provides that it does not address the application of section 7701(o) to transactions among unrelated partners. Depending on the specific facts, section 7701(o) may apply to transactions among unrelated partners. Additionally, the Revenue Ruling provides that penalties under section 6662(b)(6) or section 6662(i) could be assessed for a nondisclosed noneconomic substance transaction.

KPMG observation

As mentioned above, this revenue ruling appears to stand for the proposition that a basis adjustment achieved in a transaction that lacks economic substance as articulated by the ESD (i.e., section 7701(o)) is disallowed. Thus, if transactions change in a meaningful way the taxpayer's economic position and the taxpayer has a substantial purpose (apart from federal income tax effects) for entering into such transactions the transaction may be respected. However, the Revenue Ruling posits that—while differing economic interests of unrelated parties generally make it less likely that

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> unrelated partners will engage in transactions such as those in the Revenue Ruling—partnership composed of related partners may have no such disincentives. Thus, it appears that the Revenue Ruling may result in more scrutiny of related party basis adjustments for purposes of the potential application of section 7701(o).

Conclusion

If finalized as outlined and drafted the guidance packages would bring more complexity to what is already regarded as an extraordinarily complex area of law. Certain commenters have already raised the question of regulatory authority with respect to aspects of the guidance packages, and there will likely be ongoing debate as the rules continue to take shape. Nevertheless, taxpayers and their advisors should consider the implications of this new guidance on both future and completed transactions.

Treasury and the IRS have requested the public's comments with respect to both the Notice and the Proposed Regulations. Comments on the Notice are due by July 17, 2024. Comments on the Proposed Regulations are due by August 19, 2024, and a public hearing is scheduled for September 17, 2024.

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